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Policy Note for Smokefree Yorkshire and the Humber

Local Government Pension Scheme Tobacco Industry Investments – Opportunities for Divestment

Summary

This paper explores the policy and legal background to the contested issue of tobacco investments by local authority pension funds, taking into account legal opinion and commentary, case law, public policy and new research (in preparation for publication) by the authors examining pension committee reports. In addition it examines the potential impact of the Framework Convention on Tobacco Control on the long-term prospects of tobacco company investments, and how this has been considered in jurisdictions outside the UK when addressing the divestment issue. The paper concludes with policy options for consideration together with an appendix that considers some of the commonly raised barriers to divestment. A late addendum to this paper is included in response to a legal opinion that was issued around the time this paper was being finalised.

1.0 Background

Nearly all local authority (LA) pension funds invest in tobacco companies, the majority holding shares in transnational tobacco corporations (TTC)), namely British

American Tobacco, Imperial Tobacco Group, Japan Tobacco International and Philip Morris. In 2012 these direct investments were estimated to be valued at £1.7 billion, comprising 1.2% (range 0-3%) of aggregate fund valuations. When LAs in England acquired new public health duties in April 2013, and became responsible for reducing smoking and leading on tobacco control, they were faced with a dilemma. Smoking is by far the largest cause of preventable premature death in England, and the largest single factor driving health inequalities. There was a claimed contradiction between this new public health role on the one hand, and pension fund investment policies on the other.

2.0 Statutory Governance of the Local Government Pension Scheme

At this time the Local Government Pension Scheme (LGPS) was in the midst of reform itself as a consequence of the Public Service Pensions Act 2013, which saw the creation of a new body, the LGPS Advisory Board. This Board has both a proactive and reactive role, and seeks to encourage best practice, increase transparency and co-ordinate technical and standards issues on behalf of all local government pension funds in England. The Board has responsibility for advising the Secretary of State on the desirability of changes to the scheme, and also to local pension fund boards on the effective and efficient administration of the scheme. The Secretary of State also has powers to make regulations in relation to the LGPS as he considers appropriate giving guidance or direction.

2.1 Legal opinions on the scope for divestment

Such was the concern about tobacco investment within local government, that the Board commissioned a legal opinion from Nigel Giffin QC which was published in April 2014 to answer two questions:

1. Does an LGPS administering authority owe a fiduciary duty and if so to whom is it owed?

2. How should the wider functions, aims or objectives of the administering authority influence the discharge of its LGPS investment duties?

Giffin advised that fiduciary duties (and public law duties) are owed both to scheme members and employers. In relation to the second question he stated:

> *"The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way). However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such*

considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority)."

Giffin's comments reflect *Harries v Church Commissioners* (1992) which took the view that wider considerations (which could include public health implications of investment, although this was not specified in the case), such as public health policies, could be taken into account where to do so would not risk 'significant financial detriment.' In summarising Giffin's advice, the Board stated on its website that:

"an administering authority may choose to take into account the public health implications of tobacco investment but only if the result of such consideration is the replacement of these investments with assets producing a similar return."

In effect, the Board has left it to individual local authority pension committees to consider the matter.

Since the publication of Giffin's opinion, the Law Commission has also published its final report on fiduciary duties, which, although non-binding, constitutes a form of persuasive authority on the matter. The Commission endorsed Giffin's reliance on *Harries* in outlining administering authorities' duties and provided additional guidance on the relevance of ethical, social and governance issues to administering authorities' investment decisions. It concluded that pension fund trustees (which include administering authorities for this purpose[1]) have been too narrow in their understanding of fiduciary duties, often due to risk averse legal advice, and have unnecessarily restricted their consideration of ethical, social and governance issues.

2.2 Financial and non-financial factors in decision making

In particular, the Commission makes a distinction between financial and non-financial factors, making it clear that trustees should always take into account financial factors.

'Financial factors are any factors which are relevant to trustees' primary investment duty of balancing returns against risks. A non-financial factor is one motivated by other concerns, such as improving members' quality of life or showing disapproval of certain industries. The distinction between financial

[1] LGPS administering authorities are not subject to the same duties as pension fund trustees. Administering authorities manage funds on the basis of specific statutory powers and duties, rather than the pensions legislation and general trust law. These differences have led to uncertainty about which investment factors authorities may take into account when investing. It is likely that rules similar to those that apply to trust-based schemes also apply to the LGPS.

and non-financial factors may be illustrated with an example. ***Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor****. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.'*

In respect of non-financial factors, the Commission stated that these may be taken into account if two tests are met: 'trustees should have good reason to think that scheme members would share the concern'; and 'the decision should not involve a risk of significant financial detriment to the fund.' This essentially reiterates the views of Giffin and Harries, but only in relation to non-financial factors. The opinion of the Law Commission is clearly that ethical, social and governance factors may amount to financial factors that should be taken into account.

2.3 Risk, return and past performance

The difficulty with such formulations as 'significant financial detriment' is that it is impossible to predict future financial returns from particular stocks. As the Commission notes:

> *'Trustees are required to balance returns against risk. This is not a question of maximising returns: risks matter just as much as returns. Not all risks can be quantified. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight.'*

Local authority pension committee chairs are often quoted in the media as stating that they have a duty to maximise returns. The Commission's observations indicate that such a narrow interpretation of their fiduciary duties is incorrect. Furthermore, the Commission states that decisions on investments are matters of judgement that cannot be reduced to numbers alone and, following the Kay Review of UK Equity Markets and Long-Term Decision Making, reaffirmed that past performance is "*virtually no guide to future performance.*", This observation reinforces the point that the future performance of any particular stock or sector is unpredictable, and calls into question approaches which seek to use past performance of tobacco companies as reliable predictors of future performance, an approach commonly observed in reports to pension committees.

On the method to be used in arriving at an appropriate mix of investments that balance risk and return, the Law Commission offers further guidance:

> *'When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it*

treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action. Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk'

Many of these factors apply to the tobacco industry, not least the risks of legal and regulatory action. On how these factors should be integrated into investment decisions the Commission noted that the law 'does not prescribe a particular approach' and that 'it is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account.'

In summary, while the law is untested, it appears to be the case that ethical, social and governance issues **should** be taken into account by pensions committees where they constitute financial factors. If, however, they are non-financial factors then they may only be taken into account if additional tests are met.

3.0 Tobacco Control

3.1 The Framework Convention on Tobacco Control

In all of the foregoing, no consideration was given to the Framework Convention on Tobacco Control, a legally binding international public health treaty to which the UK is a signatory.

The United Kingdom enters into obligations to the international community when it signs an international treaty. The terms of such Treaties and their associated guidelines to compliance can place requirements on the Parties to the treaty, including subsidiary levels of government, such as local authorities. Guidelines are documents produced by the Parties to the Treaty to assist the Parties in achieving compliance with the Treaty obligations. The Guidelines to Article 5.3 apply to setting and implementing Parties' public health policies with respect to tobacco control. They also apply to persons, bodies or entities that contribute to, or could contribute to, the formulation, implementation, administration or enforcement of those policies. A recent legal opinion commissioned by the Trading Standards Institute from Richard Roberts QC, indicates that by virtue of the fact that the FCTC has been adopted by the EU it is likely that public authorities in this country are bound to comply with it. Domestic legislation is not required in these circumstances.

While the Guidelines are not binding, the opinion notes that they are likely to be taken into account by a court in deciding whether Parties are in compliance with the Treaty and in particular Article 5.3 and that, in practice, public officials should only depart from them having given careful consideration to the consequences and documented their reasons for doing so. The Article 5.3 Guidelines recommend that no branch of Government, including local government, should have any financial interest or investment in the tobacco industry.

3.2 The Potential Impact of the FCTC on Tobacco Company Earnings

The objective of the FCTC is to enable the international community to protect present and future generations from the health social environmental and economic consequences of tobacco and to reduce continually and substantially the prevalence of tobacco use and exposure to tobacco smoke.

As a signatory to the FCTC the UK has committed *"to reduce continually and substantially the prevalence of tobacco use."* That public policy objective, which has cross-party support, is directly contradicted by UK public sector investments in tobacco companies, such as through the LGPS, as the tobacco companies work to undermine tobacco control policy, and seek to block or delay tobacco control measures, both domestically and internationally. In doing so, tobacco companies are acting in the best financial interests of their shareholders and ultimate owners, including LGPS funds, to maximise shareholder returns.

3.3 Domestic tobacco control policy

The English national tobacco control plan aims to reduce smoking prevalence, in line with the FCTC commitment and specifically to cut the number of smokers by 210,000 every year. There has been substantial investment in smoking cessation by the NHS, a service that is now commissioned by local authorities. Government has also invested heavily in mass media campaigns, to both reduce uptake and encourage cessation. These measures, combined with other evidenced based policies in place including taxing tobacco products, restrictions on marketing and smoking in public places, are expected over time to reduce the number of smokers in the UK. Indeed, declining smoking rates in the UK are testament to its effective tobacco control measures, independently recognised as the most effective policies in Europe.

It is considered likely that following the forthcoming general election there will be moves to set policy for the so-called 'end game' for smoking, seeking a reduction in smoking prevalence to below 5% (from the current 20%), a step already taken by some other jurisdictions such as New Zealand. The direction of travel was made clear by the former Secretary of State for Health Andrew Lansley when he said in 2012, "We are trying to arrive at a point where they (tobacco companies) have no business in this country."

3.4 International tobacco control policy response to the FCTC

Importantly, similar measures are being adopted in numerous jurisdictions around the world, including countries where TTCs have hitherto encountered little regulation such as Russia and India. Sales volumes have fallen in recent years and continue to do so in most major markets. Measures to restrict marketing and advertising, including standardised packaging, are expected to reduce the ability of companies to charge premium prices. Furthermore, tobacco control policy learning appears to be accelerating; with, for example, standardised packaging of tobacco now on the agenda in many important markets having been successfully introduced in Australia. The proposal for a tobacco industry levy in the UK, if successfully introduced, may also be taken up in other relatively high tax jurisdictions further reducing tobacco company earnings where monopoly like profits may otherwise accrue, due to limited competition and the ability to mask significant before tax price increases on high end products.

3.5 Implications of tobacco control for pension funds

Local authority pension funds are required to set down in the statement of investment principles the extent, if at all, to which ethical, social and governance considerations are taken into account in the selection, retention and realisation of investments. Following the guidance of the Law Commission, administering authorities' Statements of Investment Principles should be redrafted to take account of the fact that ethical, social and governance considerations must be taken into account where they are considered to have a financial impact. Hitherto, many LGPS funds have decided not to consider these matters at all.

The cumulative effect on tobacco industry returns of measures introduced in accordance with the FCTC is likely to constitute a financial factor. Furthermore, there is growing evidence of the tobacco industry's recent involvement in the illicit tobacco trade, including one TTC recently being heavily fined coming on top of overwhelming evidence of historical involvement in this illegal trade. This involvement presents new litigation risks in addition to continuing and future lawsuits in many jurisdictions. As a consequence, administering authorities should be considering whether or not to continue to hold tobacco investments. Furthermore, pension funds which have considered whether or not to divest from tobacco companies that did not consider the implications of the FCTC and the national tobacco control plan on the future financial performance of tobacco stocks should revisit those decisions.

4.0 Tobacco industry divestment in action

Individual consideration of the above issues by administering authorities at the local level arguably constitutes a poor use of public funds. The powers of the Advisory Board and Secretary of State allow them to be considered more efficiently at the national level, as has occurred in New Zealand and Norway, which warrant further examination.

The New Zealand (NZ) Superannuation Fund Guardians decided in 2007 to divest from tobacco stocks following a detailed review. The Fund has a responsible investment policy and is also charged with:

- Best practice portfolio management
- Maximising return without undue risk to the Fund as a whole
- Avoiding prejudice to New Zealand's reputation as a responsible member of the world community

Provided there is no conflict with the matters listed above, the Guardians may also consider other matters including whether the issue is contrary to New Zealand law and international agreements the New Zealand Government is party to or is inconsistent with Crown actions.

Following a review the Guardians concluded that investment in tobacco stocks was not inconsistent with best-practice portfolio management or maximising returns without undue risk, **but** neither was divestment and exclusion of tobacco stocks. They also concluded that there was only a small risk that New Zealand's reputation would be damaged by continued investment in tobacco stocks. However, in considering the regulatory environment, the Guardians considered continued investment to be inconsistent with the NZ governments FCTC commitments, and in addition, that **actions arising from the FCTC obligations may have a material negative impact on the long-term growth and profitability of the tobacco industry**, and therefore runs counter to the aims of the industry and its shareholders. Furthermore, investment was also regarded as inconsistent with major government actions, including the national plan for tobacco control.

In Norway, the Pension Fund Global (the world's largest pension fund by value) was advised in 2009 by the Council of Ethics, an official advisory body, to divest from tobacco, on ethical rather than financial grounds. The reasons stated for the change were the advent of the FCTC and a tightening of Norway's own laws on tobacco. The Minister of Finance at the time was quoted as saying that 'It is important that the ethical guidelines reflect at all times what can be considered to be commonly held values of the owners of the Fund', namely the people of Norway.

4.1 Constructive engagement

Even when such concerns are accepted, divestment is not usually the preferred response. The possibility of engaging with the companies, rather than divesting, is usual practice under the UN Principles for Responsible Investment initiative. In New Zealand, the crucial factor in the decision to divest was that engagement would have very limited impact on product safety, which is the core issue, given that 1 in 2 long term smokers is killed by smoking and that knowledge of the health harms of smoking since the 1950s has led to very little change in product safety. The main aim of tobacco companies, and indirectly their shareholders, is to grow sales revenue from tobacco products, through expanding and renewing the customer base. This was considered contrary to New Zealand's national policy objectives under the FCTC which aim to significantly reduce the prevalence of tobacco use.

4.2 Effect of divestment on fund performance

The subsequent performance of both the NZ and Norwegian Funds underlines that divestment does not unduly affect portfolio growth. As table 1 shows, both funds have substantially outperformed UK LGPS Funds, including the West Yorkshire Fund which has the largest exposure to tobacco.

Pension Fund Performance Table (% return to 2014)[2]		
	1 yr	**5yr**
New Zealand Superfund	19.4	17.0
Norway Global	15.9	12.0
UK LA average	6.4	12.7
Greater Manchester	7.0	12.7
West Yorkshire	4.8	12.1
East Riding	7.1	14.0
North Yorkshire	12.0	Not stated[3]
South Yorkshire	5.7	12.7[4]
Somerset	7.5	13.9
Cornwall	4.6	11.0

[2] Source: Annual reports of the individual funds 2013/14, except Norway calendar year 2013.
[3] North Yorkshire report states ranked first in LGPS funds but does not give figure.
[4] Estimated from bar chart.

4.3 The Role of the Advisory Board and Secretary of State

The LGPS Advisory Board has not given consideration to the FCTC and its potential financial impact on tobacco investments, nor with the odd exception have individual pension funds. The Law Commission's report clearly implies that Funds should do so, therefore the question arises as to how this might be brought about. There appear to be several ways this could be done and in which the Directors of Public Health could collectively play a role:

Option 1. The Advisory Board might itself decide that it should address this issue. To do so, it could seek advice on the full range of issues outlined in this report, in a similar manner to the approach taken in New Zealand and Norway. Such a review might be triggered by requests from individual local authorities, the Local Government Association, or the Association of Directors of Public Health (ADPH), citing the FCTC, both in general and with specific reference to Article 5.3 and the guidelines, and the fact that individual authorities have not, according to our research, taken account of the relevance of the FCTC to tobacco companies future financial performance. The ADPH should ensure that it is able to give evidence to any such review on the potential impact of FCTC measures on the long-term prospects for tobacco stocks, as well as the public health and economic impacts of tobacco on the population. The Advisory Board might then reach the conclusion that tobacco investments are not a sound long-term investment for pension funds due to the implications of the FCTC and UK government policies, as was the case with those other jurisdictions, and advise the Secretary of State with a view to him issuing a Direction to divest to individual funds.

Option 2. An alternative approach would be for the Secretary of State to formally request the Advisory Board to consider whether LGPS Funds should divest from tobacco stocks. The Secretary State's justification for intervening covers the potential financial implications of regulatory action arising from the FCTC, the decisions of similar Boards in New Zealand and Norway, UK Government tobacco control policy, and the relevance of Article 5.3 to local authorities continuing investment in tobacco stock. In addition, he may highlight that LGPS investments in tobacco stocks undermine government policy by suggesting to the public that it is not fully committed to reducing smoking prevalence, and may undermine local authority tobacco control and smoking cessation programmes, and by implication undermine compliance with the aims of the FCTC.

Option 3. A third option would be for the Secretary of State to make regulations in accordance with his powers under the Public Service Pensions Act 2013 which direct LGPS funds to divest tobacco stocks from their portfolios and exclude tobacco stocks from future investment. Such a direction would be made after consultation with relevant interested parties. By investing in tobacco companies whose objective is to grow sales and increase smoking prevalence, LGPS funds are effectively undermining the UK Government's local, national and international public policy objectives to reduce tobacco use.

Option 4. In the event that the Advisory Board and/or Secretary of State do not consider these questions, or do not recommend or direct divestment, a final alternative is for Directors of Public Health to seek a change in the law prohibiting LGPS pension funds (and other public sector bodies) from investing in tobacco companies. Such a proposal for legislation or regulation might be included in a new tobacco control plan arising after the general election.

In addition to the above, there is a need for the Secretary of State to take steps aimed at strengthening the regulations and guidance on ethical, social and governance matters. At present the relevant regulations leave decisions on these matters to the discretion of individual pension funds. Given the view of the Law Commission it would be appropriate for the Secretary of State to either amend regulation 12 of the 2009 Regulations, or to issue guidance under regulation 12(3) requiring funds to set out their policies in relation to financial and non-financial factors under regulation 12(2)(f).

For Directors of Public Health seeking to address this issue at a local, rather than national level, the appendix may assist with addressing common objections and issues raised in previous committee reports to pension committees in England and Scotland.

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Key Points:

1. Local Government Pension Scheme (LGPS) funds should, in law, take account of ethical, social and governance matters, if those matters may materially affect the long-term financial performance of stocks, such as those of tobacco companies.

2. The Framework Convention on Tobacco Control (FCTC) commits the governments of 178 countries responsible for 90% of global population to "continually and substantially" reduce smoking prevalence.

3. Other jurisdictions have determined that actions arising from implementation of the FCTC may have a material negative impact on the medium to-long-term growth and profitability of the tobacco industry. The available evidence from New Zealand and Norway suggests that these divested funds have subsequently outperformed UK LGPS funds.

4. LGPS funds are NOT required to maximise returns; they are required to balance risk and return across their portfolios.

5. Not all investment risks can be quantified in mathematical terms. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight. Past performance should NOT be regarded as a guide to future performance.

6. The FCTC is likely to be directly applicable to local authorities in the UK by virtue of the UK's membership of the EU, and all the Guidelines for implementation are likely to have juridical significance. The Guidelines to Article 5.3 of the FCTC recommend that local government should not have investments in tobacco companies.

7. The LGPS Advisory Board should commission a review of tobacco industry investments having regard to wider public policy objectives including obligations under the FCTC, the FCTC's financial effects on tobacco company earnings in the medium to long-term, and the reasons for divestment decisions in other jurisdictions.

8. The Secretary of State (DCLG) has the power to make regulations directing that LGPS funds divest from tobacco stocks.

Addendum

Policy Note for Smokefree Yorkshire and the Humber

Local Government Pension Scheme Tobacco Industry Investments – Opportunities for Divestment

As this policy note was being finalised, Suffolk County Council published on its website a new legal opinion commissioned from Nigel Giffin QC, specifically on the issue of tobacco divestment. This opinion came too late to incorporate into the body of the report. This addendum considers the significance of this new opinion.

Giffin reiterates the advice he has previously given to the Local Government Association, which focuses in particular on whether or not there is likely to be significant or material financial loss arising from a divestment decision. He refers to the advice received by the Suffolk Pension Committee from the investment managers retained by the Council. They all consider that there would be at the least the potential for some material disadvantage to the pension fund. Much store appears to be placed on past performance data, despite the acknowledgement that past performance is not a guide to future performance, He goes on to conclude that this information is sufficient for the committee to decide against divestment, and goes further in concluding that divestment would be unlawful, based on the professional advice received.

However, he also acknowledges several important issues in reaching that conclusion. In particular, he acknowledges that other councils have reached differing conclusions and that some of the authorities concerned may have acted on the basis of their opinion that tobacco will be a poor investment in the future (because of the risk of regulatory action or large scale litigation). Giffin has not examined these decisions, but acknowledges that they may be legitimate as they were based on a judgement about long-term financial prospects, rather than ethical or social grounds. This is consistent with our own analysis, and in particular allows for the view that the risks from regulatory action arising from implementation of the FCTC are significant and should be taken into account. Giffin himself does not address risk from the FCTC, but does acknowledge the need for a long term perspective.

As the Law Commission noted decisions about future performance are not mathematical ones based on past performance, but judgements taking into account a range of material factors. It does not appear, for example, that Giffin has considered the fact that governments for 90% of the world population are committed to continually and substantially reducing smoking prevalence. That fact alone might lead a pensions committee to, at the very least, question the long term prospects for tobacco investments, and perhaps to conclude that remaining invested in tobacco risks significant financial detriment to the fund, in the long-, if not the short-term.

Giffin acknowledges that “It is possible, at any rate in theory that different or additional factual information might point to a different conclusion. It is certainly open to the Council to seek further information, or informed investment advice, if it considers it appropriate to do so. However, the Council has in my opinion already done at least sufficient to discharge its obligation to take reasonable steps to inform itself properly before coming to a conclusion.”

In taking advice only from its current investment managers and advisers, and in particular in failing to consider the implications of regulatory action arising from the FCTC on the long term prospects of tobacco companies, we would argue contrary to Giffin, that the Council is not properly informed about regulatory risk, and therefore has not taken sufficient steps to reach a conclusion.

In conclusion, this new legal opinion does not, as it may at first appear, rule out divestment. On the contrary it acknowledges that the council may seek additional advice, and that it might reach a different conclusion having done so. This is consistent with our own analysis, which argues that local authorities have hitherto failed to consider the full implications of FCTC implementation in the long term.

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Appendix

Addressing barriers to divestment

Analysis of reports to pension committees on divestment from tobacco stock by council officials has identified a number of commonly identified issues that are considered by those officials to be practical barriers to divestment, set out as problems below, with suggested responses.
Where officers seek external advice, it is essential to ensure this advice is truly independent and not produced by firms with links to the tobacco companies.

1. The Slippery Slope

Problem:
The question is often raised of "what next" if we divest from tobacco. It has been suggested for example that Directors of Public Health will seek further divestments regarding alcohol, fast food, gambling etc. Similarly, pressure groups often seek divestment from companies which are of concern to them such as fossil fuels in relation to climate change, or arms companies. Pension committees cannot possibly consider all divestment requests made on ethical, social and governance grounds.

Response:
Tobacco is a uniquely hazardous consumer product killing half of its longterm users. Unlike alcohol, fast food and gambling, there is no safe level of smoking. This unique status is the reason we have the FCTC. This global regulatory infrastructure is likely to have financial implications for tobacco investments. No such measures exist in relation to the other product classes mentioned.

There are very few investments where international Treaties to which the UK is a signatory are relevant. Other than the FCTC, there are several arms control treaties which ban certain weapons systems, such as cluster munitions and anti-personnel mines.

For these banned weapons, and for fast food, alcohol, etc, constructive engagement with the companies concerned may be an appropriate response to ethical concerns. For example several companies that manufactured cluster bombs or parts for them, decided to withdraw from that market in response to investor concerns.

Constructive engagement with tobacco companies regarding corporate social responsibility is not an appropriate response as it is the fundamental safety of the product that is at issue and there is no evidence that such engagement has ever achieved positive outcomes.

Pension committees may wish to use the existence of international treaties to which the UK is a signatory as a guide or 'line in the sand', on what investments they will consider for divestment.

It is also worth noting that in a Consultation Paper the Law Commission stated that, 'Trustees should not invest in activities which contravene international conventions' (para 14.25), citing the Convention on Cluster Munitions. The Local Authority Pension Fund Forum (LAPFF) agreed with this position. However, in its final report, under challenge, the Law Commission accepted that investment in foreign companies producing cluster munitions was not illegal in the UK and therefore stepped back from this position. However, the implication here is that domestic law is out of step with the UK's international commitments, and that in lobbying for tobacco divestment, it could be helpful to reference other international treaty obligations such as those covering cluster munitions. Several EU countries have banned such investments in domestic law. Should political lobbying on tobacco divestment be pursued there may be advantages in framing the issue, to some extent, around wider Treaty obligations than just the FCTC, but this will require deeper consideration.

2. Performance measurement and pooled funds

Problem:
Fund managers' performance is measured against benchmarks, relevant to their particular portfolio eg UK, World. Their financial rewards may be linked to the performance of the stocks under their management relative to the benchmark. Excluding tobacco means the standard benchmark is no longer a reflection of the "investable universe" for the fund manager. Therefore bespoke benchmarks will need to be constructed which take account of the excluded stocks. In addition, most LGPS funds have some or all of their tobacco investments held within pooled funds. These are financial products offered by fund managers which contain numerous separate company stocks. LGPS funds cannot divest from the individual stocks, only the pooled fund itself.

Response:
Many fund managers are content, when asked, to be measured against existing benchmarks, as they do not see tobacco as a major factor in their performance. However, UK Index focused managers holding stocks in Imperial Tobacco and British American Tobacco, both FTSE100 companies, either directly or in UK focused pooled funds such as the FTSE100 tracker, are more likely to raise objections, as these two stocks comprise about 5% of the FTSE100 index by value. In contrast, tobacco is a much smaller proportion of world indexes.

Alternative benchmarks do exist. For example, the MSCI ex tobacco and controversial weapons index excludes tobacco and controversial weapons systems, which might be considered suitable, depending on the degree of exposure of the fund manager to relevant arms companies. Blackrock offers a fund that matches this index.

If all UK LGPS Funds were to divest from tobacco, the cost of a bespoke index is likely to be minimal when spread across all funds. The market may well respond to such a decision by creating an index, and indeed create pooled fund products that match current benchmark indices with the exclusion of tobacco. There are only a limited number of tobacco companies, which are well-defined, (with19 on the Norwegian government list). A UK index benchmark would simply exclude the two FTSE100 companies.

Fund managers making a switch from current pooled funds to new ex-tobacco funds are likely to incur some costs arising from fees for switching. If a national level divestment decision is made, market forces in search of a share of around £2 billion of tobacco investments in segregated and pooled funds are likely to result in price competition to secure investments. Experience from overseas funds that have divested may be helpful in understanding cost implications of changing investments.

It should also be noted that many overseas funds have divested from tobacco (and often controversial weapons systems too), so must be effectively measuring performance of fund managers to their satisfaction. Advice could be sought from these pension funds.

3. Risk of legal challenge

Problem:
Several pension committee reports express concern about the risk of legal challenge. For example:

> "A challenge could come from (say) a council taxpayer because pension fund returns have suffered as a result of operating an exclusion policy. Also, a challenge could come from a council taxpayer who disagrees with the ethical judgment of the pension committee, and has his/her own (different) views of which investments should be excluded. (Northumberland)"

Response:
It is important to differentiate between the likelihood of a legal challenge, and the likelihood of a successful legal challenge. Many of the officer opinions predate the Law Commission report with its clear distinction between financial and non-financial

factors. There is precedent from New Zealand that tobacco regulation is a financial factor, as the Board of Guardians determined that tobacco regulation arising from the FCTC and national policies may have a material negative impact on the long-term growth and profitability of the tobacco industry.

After proper consideration of all material factors, including taking both professional financial advice, and advice on the likely long-term impact of the FCTC, a pension committee has the power to effectively agree with the view of the New Zealand Board and choose to divest. Provided due process is followed and the issue is not pre-judged, then while a legal challenge cannot be ruled out, the apparent widespread perception within local authorities of a successful legal challenge appears overplayed.

Furthermore, a legal challenge is unlikely to come from scheme members as beneficiaries' pensions are based on defined benefits, so not in themselves dependent on fund investment performance. Giffin also advised (prior to the Law Commission report) that it is unlikely that the administering authority would be liable for damages to other employers in the scheme for breach of duty of care by negligence.

Finally, it is also important to note that concerns over legal challenges in committee reports is typically based on the risk of litigation arising from divestment. Interestingly, no consideration is given to risk of legal challenge arising from failure to consider relevant financial factors, such as regulatory risk arising from the FCTC, in considering whether or not to divest. This reflects the fact that few reports begin to broach the financial ramifications of the FCTC on tobacco stock. However, given that the bar for successful judicial review is set quite high, the likelihood of legal challenge at all is, in our view, minimal, provided due process is followed.

4. Past performance as a guide to the future

The problem:
It is common practice in reports by council officials providing guidance on divestment to pension fund committees to use calculations based on past performance to estimate the impact of divesting from tobacco. This is reported historically, with actual performance over, say, the previous 5 years, compared with how that would have differed without tobacco stocks and with a presumption that future performance is likely to follow a similar pattern. This approach, often reflecting advice provided by fund managers, structures decisions against divestment as the past performance of tobacco stock has proved quite strong and the stock itself has also suffered less volatility than the stock market average.

Response:
The Law Commission, citing the Kay review, confirms that “Past performance is virtually no guide to future performance”. The point is sometimes acknowledged in officers’ reports, which nevertheless go on to use past performance as a guide to decisions. Tobacco volumes are declining in most major markets. FCTC derived regulation is accelerating this process. DsPH should challenge the use of past performance as a guide to the future, and emphasise the increasing regulatory risks to profitability in the medium to long term. 90% of the world’s population is covered by the FCTC with 178 countries committed to reducing “continually and substantially” smoking prevalence. The USA and Indonesia are the notable non-signatories, but due to strong domestic policies the USA is also seeing significant falls in smoking prevalence.